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October 26, 2004

***To the Citizens of the Commonwealth of Massachusetts,
Governor Mitt Romney, and Honorable Members of the
General Court***

I am pleased to present to you the Statutory Basis Financial Report (SBFR) of the Commonwealth for the fiscal year ended June 30, 2004 (FY04).

The Commonwealth has weathered the worst of the economic downturn over the last two fiscal years. Tax revenues from all sources increased by 8.6% after dropping 15.2% in FY02 and moderately increasing in FY03. Unemployment continues to be slightly better than the nation, beginning the fiscal year at 5.8% and ending the year at 5.3%. Inflation in the Commonwealth remains low at a non-seasonally adjusted 2.91% from July 2003 to July 2004. Fuel and transportation prices rose nearly twice the rate of inflation, with the cost of medical care and education not far behind.

The Commonwealth continued to make difficult decisions to meet these challenges that lie ahead.

- Twenty-four departments were involved in either mergers or reorganizations in an effort to streamline government.
- In July 2004, the Governor signed into law an act that centralizes transportation planning and oversight. Transportation authorities such as the Turnpike and the Port Authority will remain legally separate, the Secretary of Transportation will serve as either chairperson or as a board member of those authorities beginning in FY08.
- Following the closure of 51 funds last year, the Commonwealth now has a clearer definition of net surplus.
- To limit spending during the year, the Commonwealth began to temporarily hold aside tax revenues that represents growth in excess of inflation.
- We also invested nearly \$85 million via an economic stimulus package, channeling funds to technology, education and economic development.
- The Commonwealth continued to appropriate all of the tobacco settlement revenues in FY04, though transfers from Stabilization Fund not reimbursed by held aside tax revenues were largely used for a final supplemental budget, funding Medicaid and other health – related spending, additional local aid, capital projects and other items.

- The Commonwealth escrowed portions of the federal Medicaid additional assistance to states afforded from the federal Jobs Growth Reconciliation Act of 2003.

Additional challenges lie ahead. Pension funding costs in FY05 are estimated to nearly double FY04, due to the actuarial phase-in of market losses in previous years, and the delay of the transfer of the Hynes Convention Center to the Commonwealth Retirement System to fund pension costs and early retirement.

For the first time in a decade, the Unemployment Compensation Fund had to borrow from the federal government to pay unemployment benefits. All of the loans were repaid by June 30, 2004. The city of Springfield has come under fiscal oversight. The Commonwealth has appointed a fiscal control board and authorized \$52 million in loans to help the city. In early July, the Commonwealth ended a decade long debate on funding school construction, creating a new authority and dedicating a portion of sales tax revenue over and above amounts already pledged for the Convention Center and the MBTA to fund these projects. Finally, medical care and Medicaid in general will continue to rise faster than the rest of the budget.

I am reporting that the Commonwealth finished the year ended June 30, 2004 with a budgetary surplus of approximately \$1.89 billion. Of this amount \$1.1 billion is sequestered in the Stabilization Fund. This surplus represents slightly over thirty-four days of budgeted operations. In spite of the overall improvements in the economy the challenges detailed above mean that our financial picture will remain cautious for the near future.

Financial Highlights

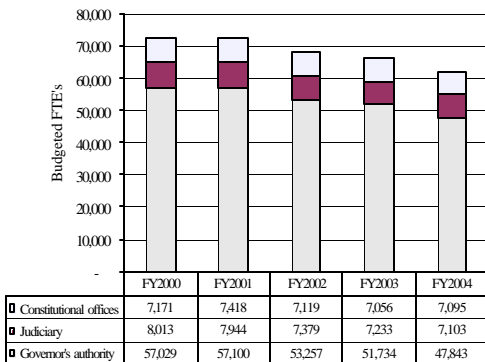
To meet the challenges of this fiscal year, the Commonwealth continued to take extraordinary measures to maintain fiscal balance.

- \$531 million was transferred from the Stabilization Fund to pay for current expenditures. However, at the close of the fiscal year, \$357 million was redeposited into the fund from tax revenues held aside during FY04. An additional \$663.5 million was transferred to the fund from surplus. Also, nearly \$700,000 was recovered from Central Artery Project Costs. Beginning in FY06, an additional 0.5% of current year net tax revenues must be deposited into the Stabilization Fund before the year – end surplus is determined in addition to the current statutorily required carry-forward amount. Finally, the ceiling on the balance in the Stabilization Fund was increased from 10% to 15% of total current year budgeted revenues.
- All of the tobacco settlement proceeds for the year were used in support of current operations.
- The Commonwealth refunded over \$2.8 billion in General Obligation Bonds and Grant Anticipation Notes, continuing to take advantage of some of the lowest interest rates in history.

The Commonwealth continues to refrain from issuing tobacco settlement bonds or pension obligation bonds, which many of our peer states have either considered or sold.

- To fund a deficit in the Unemployment Compensation Fund due to higher payments to recipients than receipts, the Commonwealth received interest-free loans from the federal government between January and April 2004, incurring a net total liability of \$417.9 million. All of these borrowings were paid back in May 2004. The balance of the fund remains low at \$122.5 million, below 5% of FY04 benefits paid.

***Budgeted Full Time Equivalent
Workforce
Including Budgeted Higher Education
June 2000 – June 2004***



The Commonwealth also took measures operationally to achieve balance.

- The budgeted full time equivalent workforce including higher education, dropped from 66,023 as of June 2003 to 62,041 as of June 2004. The graphic to the left details the reductions over the last five years.
- Starting in FY04, the employee's share of group health insurance premiums increased from 15% to 20% of the cost of the insurance for those who earn more than \$35,000. All new employees hired after June 30, 2003 contribute 25% of the cost of the insurance, regardless of salary.
- Tax decreases put in place earlier than FY02 remain frozen. The income tax rate remains at 5.3%. The graduated capital gains tax portion has also been frozen at 5.3%.

Overview of the Financial Statements

This report includes the reports on the activity and balances of the budgeted funds, non-budgeted special revenue funds, capital project funds, fiduciary funds and the non-appropriated funds of higher education.

The financial operations of these funds are maintained in the Massachusetts Management Accounting and Reporting System, (MMARS). The statewide accounting system is operated by the Commonwealth and contains detailed information summarized in this report. This system, in place since 1986, is in the process of being retired as it is being replaced by a web – based system for FY05.

The SBFR is intended to satisfy the requirements of state finance law, and to present fairly the results of FY04 activity in the Commonwealth's funds. The report contains computations required by state finance law, including the certification of transfers to and balances in the Stabilization Fund and Tax Reduction Fund.

Basis of Accounting

The statutory basis of accounting, defined in Massachusetts law, is used to budget and control fiscal operations. The statutory basis of accounting is not in conformity with accounting principles generally accepted in the United States of America, (GAAP) as defined for governments by the Government Accounting Standards Board (GASB). This report's purpose is to document compliance with Massachusetts state finance law. I will report the Commonwealth's financial position on a GAAP basis in December, in our Comprehensive Annual Financial Report, (CAFR). This report, which will be prepared in accordance with GAAP, provides a basis for comparison with other governments. There are significant differences between what is contained in the SBFR fund balance, revenues and expenditures and what will be presented in December under GAAP. The major differences include presentation of the historical cost of infrastructure (roads and bridges,) the recording of depreciation expense, the presentation of all types of debt on the face of the financial statements and the presentation of those financial statements in an all – encompassing, net assets and net expense format.

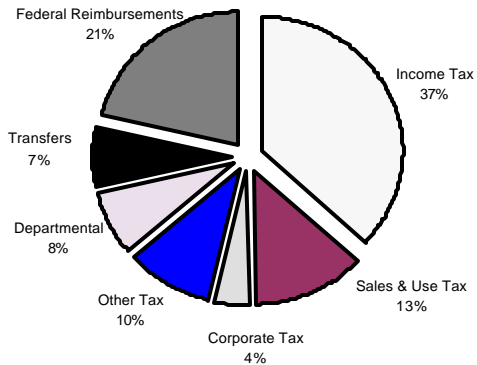
In accordance with Massachusetts General Laws, the Office of the Comptroller transmits the SBFR on or before October 31st. The SBFR report for fiscal year ended June 30, 2004 herein is audited by Deloitte & Touche, Independent Certified Public Accountants, and represents the conclusion of financial activity and the closing of the Commonwealth's books on the statutory basis of accounting for the fiscal year. This audit is conducted in conjunction with the Office of the State Auditor, which provides knowledge, expertise and resources to audit the financial statements.

The Budgeted Funds

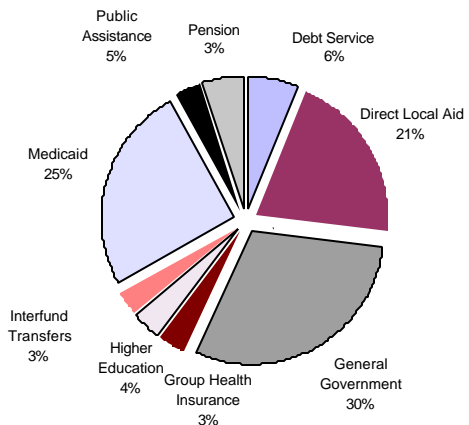
For the first time since FY01, revenues and other sources outpaced expenditures and other uses of budgeted funds, resulting in an operating surplus of over \$1.1 billion. This surplus is indicative of a rise in budgeted revenues and other sources of more than \$2.0 billion led by over \$989 million in increased budgeted tax revenues and nearly \$353 million in increased departmental revenues resulting from the full year implementation of fee increases from FY03. Budgeted expenditures and other uses were up less than 2% for FY04, largely isolated to debt service increases and interfund transfers.

Any assessment surplus or deficit should be viewed in a trend. In that assessment, generally accepted standards indicate that a structural balance is achieved when revenues exceed expenditures over a period of multiple years. After two years of financial operating deficits, reliance on the significant use of prior year surpluses slowed in FY04. Much of the accumulated prior year surplus balances had been used to balance the FY02 and FY03 budgets. As a result of FY04 operations, the Commonwealth was able to transfer \$663.5 million to Stabilization Fund. In FY05 and in future years, the challenge will be to match spending to available revenues.

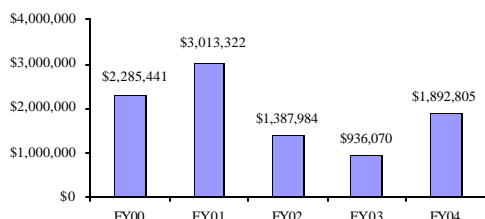
Budgeted Revenues and Other Sources



Budgeted Expenditures and Other Uses



Budgeted Funds – Fund Balance (Amounts in Thousands)



In FY04, budgeted revenues and other sources increased 9.1% from FY03, reflecting strong increases in tax revenues. Federal reimbursements rose approximately 3.8% as a result of increases in Medicaid reimbursements and nearly \$403 million received in federal Medicaid Assistance Percentage (FMAP) payments pursuant to the federal Jobs and Growth Act of 2003. From a multi-year perspective, the proportion of revenue sources by category remained stable.

Budgeted expenditures and other uses, including transfers, decreased by 3.3%. This is largely a result of actions of the Legislature to transfer budgeted pension expenditures “off-budget.” The Budgeted Funds – Operations table on page 6 displays the FY04 summary of budgeted funds, compared to FY03. The FY04 financial statements for each of the 16 individual budgeted funds are included in the financial section of this report.

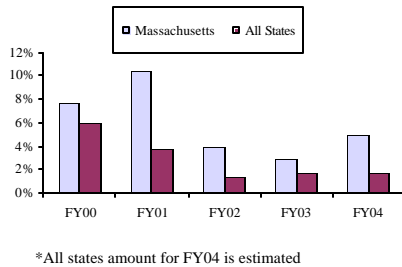
In conducting the budget process, the Commonwealth excludes those “interfund” transactions within the budgeted funds that are included in this report because by their nature, they have no impact on the combined fund balance of the budgeted funds. The table Budgeted Funds – Operations isolates this “interfund” activity from the budgeted sources and uses to align forecasts prepared during the budget process to actual amounts in this report. Transfers among the Budgeted Funds increased as a result of funds provided from Stabilization Fund to other funds to balance the budget for the year as well as year-end transfers back into the Stabilization Fund. A detailed list of these interfund transfers is included in Note 3 of this report.

The graph of Budgeted Funds – Fund Balance, portrays the combined fund balance in the budgeted funds for the past five years. This “bottom line” perspective demonstrates the accumulation of resources attributable to balanced budgets through FY01 and the reliance on these resources through FY03 as spending was adjusted to align with the lower revenue base. As part of the General Appropriation Act of FY04, the Convention and Exhibition Center Fund, a large contributor to budgeted fund balance was redefined as non-budgeted, resulting in a beginning balance restatement for FY04. Fifty other budgeted funds were either reclassified to non-budgeted, trust funds or closed as part of the General Appropriation Act, all of which are reflected as a restatement of beginning fund balance, leaving a clearer definition of budgetary activity. In FY04, the ending balance is comprised of the statutory fund balance of the General Fund, the Stabilization Fund, the Workforce Training Fund, the Massachusetts Tourism Fund and the Federal Medicaid Percentage Escrow Fund, offset by deficits in the Highway and Children’s and Senior’s Health Care Assistance Funds. Due to a final supplemental budget occurring after June 30, 2004 and other designations within these fund balances, \$1.8 billion of the total statutory fund balance is either reserved or is available for appropriation in FY05. The remainder is undesignated.

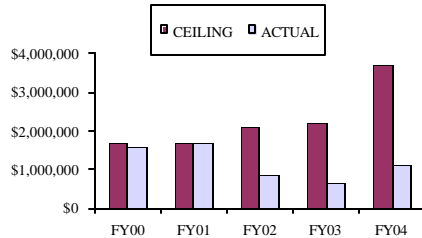
Budgeted Funds - Operations
(Amounts in thousands)

	2003	2004
Beginning fund balances:		
Reserved and designated.....	\$ 195,173	\$ 76,735
Reserved for Stabilization Fund.....	881,771	641,325
Undesignated.....	311,040	218,010
Total.....	1,387,984	936,070
Legislative fund reclassification.....	-	(183,285)
Adjusted beginning balance.....	\$ 1,387,984	\$ 752,785
Revenues and other sources:		
Taxes.....	14,279,567	15,268,976
Federal reimbursements.....	4,523,648	5,098,536
Departmental and other revenues.....	1,494,755	1,847,766
Interfund transfers from non-budgeted funds and other sources.....	1,689,198	1,773,068
Budgeted revenues and other sources.....	21,987,168	23,988,346
Intragovernmental Service Fund revenues.....	117,223	133,707
Interfund transfers among budgeted funds and other sources.....	3,193,296	1,924,930
Total revenues and other sources.....	25,297,687	26,046,983
Expenditures and other uses:		
Programs and services.....	20,022,626	20,036,542
Debt service.....	1,373,409	1,419,603
Pension.....	813,469	701,902
Interfund transfers to non-budgeted funds and other uses.....	229,579	690,279
Budgeted expenditures and other uses.....	22,439,083	22,848,326
Intragovernmental Service Fund expenditures.....	117,223	133,707
Interfund transfers among budgeted funds and other uses.....	3,193,296	1,924,930
Total expenditures and other uses.....	25,749,602	24,906,963
Excess (deficiency) of revenues and other sources over expenditures and other uses.....	(451,914)	1,140,020
Ending fund balances:		
Reserved and designated.....	76,735	664,574
Reserved for Stabilization Fund.....	641,325	1,137,320
Undesignated.....	218,010	90,911
Total.....	\$ 936,070	\$ 1,892,805

Stabilization Fund Balance as a Percentage of Budgeted Expenditures



Stabilization Fund – Fund Balance (Amounts in Thousands)



Stabilization Fund Activity in FY 2004 (Amounts in Thousands)

Balance as of June 30, 2003	\$	641,325
Add: Investment income		5,259
Recoveries of Central Artery Project Costs.....		695
Transfers from Temporary Holding Fund		357,465
Subtotal		1,004,744
June 30th Consolidated Net Surplus transfer		663,457
Subtotal		1,668,201
Less: Transfers and Appropriations from Stabilization		(530,881)
Balance as of June 30, 2004	\$	1,137,320

The Stabilization Fund

With the rapid depletion of the accumulated balances over the last three years, the importance of the balance in the Stabilization Fund and its direct correlation to the financial condition of the Commonwealth is clear. The National Governor's Association, along with the National Association of State Budget Officers in their annual "The Fiscal Survey of States" ranked the Commonwealth in FY03 fifth in the nation in terms of the balance of stabilization. Fifteen states have no stabilization balances. Even more impressive, of states with over \$10 billion in General Fund expenditures in FY03, the Commonwealth's stabilization balance, as a percentage of expenditures, was third in the nation behind Maryland and Florida. As the graphic at the left portrays, the Commonwealth has continued to outpace the rest of the nation in this key element of fiscal condition.

State finance law, as amended during FY03, increased the maximum balance that may accumulate in the Stabilization Fund to a level equal to 10% of budgeted revenues and other sources. For FY04, this ceiling has increased to 15%. The law then directs that any amount in excess of this "cap" be transferred to the Tax Reduction Fund for future, one-time, personal income tax rebates. Due to the significant transfers out of Stabilization over the last two years, it will be a while before the "cap" will be reached. The details of these calculations can be found on pages 272 through 277 of this report.

The graph, Stabilization Fund - Fund Balance portrays this "cap" and the balance of the fund over a five-year period. A balanced budget or "Consolidated Net Surplus," was redefined for FY04 to include all undesignated fund balances in the budgeted funds except for the Inland Fisheries and Game Fund. Under current general laws, an amount equal to 0.5% of tax revenues is retained in the funds contributing to the calculation. Beginning in FY05, an additional .5% of current year tax revenues must be deposited in stabilization before the year-end surplus is determined.

The trend to fragment the budget into such special interest funds was addressed with consolidation and closure of the majority of budgeted funds activity in FY03.

The Non-Budgeted Funds

The Non-Budgeted Funds represent operations in which the government has imposed its sovereign authority, but has excluded these operations from the annual budget process. During FY04, the Commonwealth maintained 47 of these funds, including certain funds that had previously been reported as budgeted. The largest non-budgeted funds include the Lottery, Federal Grants, Health Care Security Trust (designated to receive tobacco settlement funds), Grant Anticipation, MBTA State and Local Contribution Fund, the Medical Security Trust, the Health Care Quality Improvement Fund and the Uncompensated Care Funds. These funds are commonly referred to as special or dedicated revenue funds whose revenues are matched to related expenditures.

The table, Non-Budgeted Funds – Operations, includes a summary of the FY04 non-budgeted funds. Financial statements for each of the individual funds are included in the financial section of this report. Several of these funds are worth mentioning.

At June 30, 2004, the Federal Grants Fund had a positive fund balance, but there is a deficiency in cash within the fund. This cash deficiency results from the Commonwealth drawing funds from the federal government a few days after applicable cash disbursements had been made to assure an “interest neutral” timing of the federal – state cash exchange. These requirements were established by the Cash Management Improvement Act of 1990. Within the Lottery Funds, gross revenues continued to increase this fiscal year. The Lottery continues to be a strong source of cash flow for the Commonwealth.

Non-Budgeted Funds - Operations (Amounts in thousands)

	2003	2004
Beginning fund balance.....	\$ 856,096	\$ 862,572
Legislative fund reclassification.....	-	183,285
Adjusted beginning balance.....	<u>856,096</u>	<u>1,045,857</u>
Revenues and other sources:		
Taxes.....	752,775	785,642
Assessments.....	526,888	619,013
Federal grants and reimbursements.....	2,855,445	3,252,986
Tobacco Settlement revenue.....	300,039	253,621
Departmental and miscellaneous.....	4,996,883	5,406,115
Transfers and other sources.....	<u>498,872</u>	<u>1,647,220</u>
Total revenues and other sources.....	<u>9,930,902</u>	<u>11,964,597</u>
Expenditures and other uses:		
Programs and services.....	7,560,198	8,602,787
Debt service.....	77,200	96,219
Transfers and other uses.....	<u>2,287,028</u>	<u>2,719,137</u>
Total expenditures and other uses.....	<u>9,924,426</u>	<u>11,418,143</u>
Excess of revenues and other sources over expenditures and other uses.....	<u>6,476</u>	<u>546,454</u>
Ending fund balance.....	<u>\$ 862,572</u>	<u>\$ 1,592,311</u>

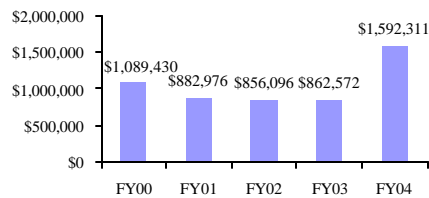
The Health Care Security Trust Fund (HST) reports all revenues received from the Master Settlement Agreement (MSA) between the states and the tobacco industry to recover healthcare costs for tobacco related illnesses. The MSA estimates the Commonwealth revenues for the first 25 years of the settlement to be approximately \$7.6 billion. However, this estimate is prior to possible future adjustments, including adjustments for inflation and changes in the volume of domestic cigarette sales. In FY04, the Commonwealth received nearly \$254 million or 89.7% of the estimated amounts shown in the MSA. All HST proceeds received in FY04 were transferred to the General Fund. The Fund was also used as a cash flow mechanism for the new Health Care Quality Improvement Fund. The decline in HST assets is directly related to this financing since the HST invested assets had a positive return on investment.

The Health Care Quality Improvement Fund (HCQIF) was established in FY03 to accept transfers of fee revenue from nursing homes, along with applicable federal financial participation transferred from the HST. In FY04, this activity generated \$287.0 million in fee revenue and related federal financial participation, along with \$308.4 million in spending. The operating deficit results from a transfer from the HST to fund legislatively mandated non-federally eligible spending.

Federal Grant Anticipation Notes, (GANS) activity related to the Central Artery / Tunnel Project (CA/T) continued this year. During FY98, the Legislature authorized the issuance of up to \$1.5 billion in GANS to finance the current cash needs of the Project. These proceeds of the GANS are being used to pay for federally eligible expenditures. From 2005 to 2015, these eligible expenses will be reimbursed by the federal government and the reimbursement will be used to payoff the GANS. As of June 30, 2004, all of the GANS have been issued. The GANS are not considered general obligation debt of the Commonwealth. Activity related to issuance of GANS and the accumulation of pledged funds and the payment of debt service is accounted for in the Grant Anticipation Note Trust Fund. In July 2003, the Commonwealth completed a cross-over refunding of the GANS. \$388.1 million in GANS issued in 1998 and 2000 at coupons ranging from 5.125% to 5.75% that will mature on December 15, 2008 and 2010, respectively, were partially refinanced with \$408.0 million of refunding notes with yields of 2.51% to 3.39%. The interest on the newly issued refunding notes is paid from an escrow until final redemption. This technique results in economic savings, but does not result in the legal defeasance of the notes. The result is the original as well as the refunding notes are reported on Commonwealth's books until the maturity dates. The \$531 million surplus in the fund for FY04 represents \$521 million held for payment of interest on the GANS inclusive of an escrow for payment of GANS involved with the aforementioned crossover refunding.

The universal health care funds, including the Uncompensated Care and Medical Security Trust Funds, have reported revenue increases of over \$1.8 billion. However, \$346.4 million was transferred out to fund operations this year due to the lagging economy. As of the end of FY04, these funds have a combined fund balance of nearly \$127 million.

***Non-Budgeted Funds –
Fund Balance
(Amounts in Thousands)***



The graph Non-Budgeted Funds - Fund Balance shows the combined fund balance in the Non-Budgeted funds for the past five years. In each year, the entire balance is designated for the specific purpose of the fund. The only component of overall growth in fund balance in these funds this fiscal year was due to deposits into the Community Preservation Trust Fund. As indicated in previous years, more consolidation and elimination is needed for these funds. For example, the Government Land Bank Fund has a chronic structural fund deficit. The FY04 deficit balance of \$35 million remains an unbudgeted drain in cash flows in the General Fund. While steps have been taken to stop the growth in this deficit, the Fund should be abolished and the deficit transferred into the General Fund. An additional \$25 million deficit exists in the Motor Vehicle Inspection Fund. Amendments to the enabling statute to the Fund mandates that the Fund must be in balance by June 30, 2009.

The Capital Projects Funds

The purpose of these funds is to account for the construction or acquisition of capital assets. The Governor may propose capital outlay budgets, which, upon enactment by the Legislature and approval by the Governor, become capital outlay acts. Capital outlay acts financed through the sale of debt require a two-thirds vote of the Legislature. Numerous acts may be combined for reporting in an individual Capital Project Fund, but each act is accounted for separately within the Capital Projects Fund. These accounts record authorizations for expenditures in itemized capital appropriation accounts and equivalent authorizations to issue bonds or notes in anticipation of federal reimbursements.

The structure of these funds is such that each capital outlay authorization is in balance, creating authorization for inflows, which may be from sales of bonds, federal reimbursements or other revenues and authorization for expenditures. Imbalances due to timing differences develop when the expenditure precedes the inflow of funds from the sale of bonds or federal reimbursements. Because of federal tax arbitrage rules, it is more difficult to sell bonds in anticipation of expenditures. The sale of bonds in advance is not commonplace in the Commonwealth.

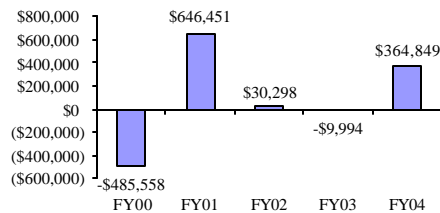
The Commonwealth issued nearly \$4.9 billion in debt this year. Of this amount, \$1.9 billion was used to fund ongoing projects and over \$2.9 billion was issued in the form of general obligation refunding bonds, taking advantage of low interest rates. These refundings generated approximately \$203.6 million in debt service savings over a number of years, equating to \$107.2 million on a present value basis.

A significant portion of the Capital Projects activity continues to relate to the Central Artery / Tunnel Project (CA/T). The CA/T has been the target of an enormous amount of public scrutiny. The Commonwealth has aggressively responded to these concerns regarding the integrity of the cost estimates. For the third year, an independent evaluation of the entire estimate for the project has been undertaken. The current cost of the project stands at \$14.625 billion. The federal government has capped its contribution to this project and the finance plan includes state

Central Artery / Tunnel Project
(Amounts in Billions)

Sources of Funds:	2003	2004
Federal Funds	\$ 7.049	\$ 7.049
GANS	1.500	1.500
Massachusetts Turnpike Authority	1.658	1.658
Massachusetts Port Authority	0.302	0.302
Other Commonwealth Debt	3.931	3.931
Commonwealth Operating Funds and Investment Earnings	0.185	0.185
Total Sources	\$ 14.625	\$ 14.625
Costs of Construction:		
Cumulative Costs at Beginning of Fiscal Year	\$ 11.655	\$ 12.728
Current Fiscal Year Spending	1.073	0.589
Actual Costs through End of Fiscal Year	12.728	13.317
Estimated Spending:		
FY04	0.939	-
FY05	0.776	0.801
FY06	0.182	0.507
Total Estimated Costs of Construction:	\$ 14.625	\$ 14.625

Capital Projects Funds –
Fund Balance (Deficit)
(Amounts in Thousands)



sources to fund the state share of the project. The project is over 94% complete as of June 30, 2004.

The east-west portion (Interstate 90) opened on January 18, 2003 and the northbound portion (Interstate 93) opened on March 29, 2003. The southbound portion (Interstate 93) opened partially on December 20, 2003. Substantial completion is expected sometime between May and September 2005.

Pursuant to statute and agreements with the Massachusetts Turnpike Authority (MTA) and the Massachusetts Port Authority (MassPort), the entities have committed to significant ongoing contributions to the Commonwealth as part of the financing for this project. These funds are in addition to funds from the Commonwealth and federal funds for the project.

The graph Capital Projects Funds – Fund Balance (Deficit) shows the combined fund balance in Capital Projects Funds for the past five years. The graph shows a surplus in the funds in FY04. However, the majority of the individual funds remain in deficit due to the timing differences between bonding and expenditures offset by surpluses in three funds. These three funds include a fund for central artery and statewide roads and bridge construction, a fund for the Commonwealth's Convention Centers and a fund for the federal highway construction program. These funds contain designated reserves or escrows where the Commonwealth is able to legally arbitrage revenues consistent with the provisions of the existing tax code.

The Capital Projects Funds – Operations table on the next page, includes the FY04 Capital Projects Funds, summarized and compared to FY03. Financial statements for each of the individual funds are included in the financial section of this report.

The Administration has implemented a coordinated fiscal strategy for the management of Capital Projects Funds. This strategy includes a five-year capital budget linked to debt management and cash management. The focus of this strategy is to manage capital spending and outstanding debt to levels the Administration considers appropriate for the Commonwealth. An important part of the strategy is to control capital spending within an annual administrative "cap."

Capital Projects Funds - Operations
(Amounts in thousands)

	2003	2004
Beginning fund balance (deficit).....	\$ 30,298	\$ (9,994)
Revenues and other sources:		
Federal grants and reimbursements.....	519	3,408
Departmental and miscellaneous.....	40,025	22,985
Payment from Authorities.....	104,914	-
General and special obligation financing.....	1,911,200	1,993,080
Proceeds of refunding bonds.....	3,398,240	2,832,866
Transfer for Federal Reimbursements.....	507,343	598,955
Transfers and other sources.....	284,750	154,428
Total revenues and other sources.....	6,246,991	5,605,722
Expenditures and other uses:		
Acquisition of assets.....	2,635,578	2,229,611
Payments to refunded bond escrow.....	3,398,240	2,832,866
Transfers and other uses.....	253,465	168,402
Total expenditures and other uses.....	6,287,283	5,230,879
Excess (deficiency) of revenues and other sources over expenditures and uses.....	(40,292)	374,843
Ending fund balance (deficit).....	\$ (9,994)	\$ 364,849

The Fiduciary Funds (Excluding Agency Funds)

The Fiduciary Funds record the Commonwealth's responsibility for assets it controls on behalf of other parties. Examples of such funds are the Unemployment Compensation and Pension Trust Funds. The table on the following page, which excludes assets held on a purely custodial capacity in so-called Agency Funds, summarizes the FY04 activity of the Fiduciary Funds. Over 89% of the Fiduciary Fund assets are related to the Commonwealth's Pension Fund detailed in fund statements found in this report.

The \$4.0 billion operating gain in this fund group is primarily the result of the net of two significant events:

- The net change in value of pension assets increased by over \$4.3 billion.
- Payments to the unemployed in the Commonwealth exceeded employer contributions to the Unemployment Compensation Trust Fund by over \$368.2 million.

The pension valuation is based on data as of January 1, 2004. Details of this valuation are outlined in Note 10. The value of pension assets of the public retirement system increased from FY03 to FY04 from 68.9% funded to 73.9% funded. This is due to improving economic conditions offset by previous years' early retirement incentive programs.

Fiduciary Fund - Operations (Excluding Non-Expendable Trusts)
(Amounts in thousands)

	<u>2003</u>	<u>2004</u>
Beginning fund balance.....	<u>\$ 28,083,520</u>	<u>\$ 27,673,480</u>
Revenues and other sources:		
Taxes.....	905,821	1,264,364
Federal reimbursements.....	744,385	831,727
Departmental and other revenues.....	1,950,375	1,943,489
Interfund transfers and other sources.....	26,245	178,553
Unrealized and realized investment earnings / (losses).....	<u>967,084</u>	<u>5,104,754</u>
Total revenues and sources.....	<u>4,593,910</u>	<u>9,322,887</u>
Expenditures and other uses:		
Expenditures.....	4,814,732	5,031,389
Interfund transfers.....	<u>189,217</u>	<u>242,995</u>
Total expenditures and uses.....	<u>5,003,949</u>	<u>5,274,384</u>
Deficiency of revenues and sources over expenditures and uses.....	<u>(410,040)</u>	<u>4,048,503</u>
Ending fund balance.....	<u><u>\$ 27,673,480</u></u>	<u><u>\$ 31,721,983</u></u>

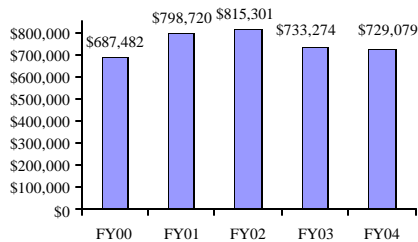
The Non-Appropriated Funds of Higher Education

The SBFR includes the financial operations of the non-appropriated funds of the 25 Institutions of Higher Education in the statistical section of this report. Each Institution of Higher Education is authorized and directed in its enabling statute to collect, retain and expend certain fees, rents, sales, donations, federal financial participation and other types of revenue through campus based systems. These financial resources are integral parts of the total financial activity of each campus. They also represent resources in addition to amounts made available from Commonwealth appropriations. Over the past few years, significant efforts have been taken by our office and the institutions to improve the accuracy and timeliness of this Higher Education segment of the financial report.

Non-Appropriated Funds Of Higher Education - Operations
(Amounts in thousands)

	2003	2004
Beginning fund balance.....	\$ 815,301	\$ 733,274
Revenues and other sources:		
Federal Grants and reimbursements.....	299,199	339,160
Departmental and miscellaneous.....	1,313,381	1,550,644
Transfers and other sources	107,274	150,694
Total revenues and other sources.....	1,719,854	2,040,498
Expenditures and other uses:		
Programs and services.....	1,646,136	1,828,735
Transfers and other uses.....	155,745	215,958
Total expenditures and uses.....	1,801,881	2,044,693
Excess (deficiency) of revenues and other sources over expenditures and other uses.....	(82,027)	(4,195)
Ending fund balance.....	<u>\$ 733,274</u>	<u>\$ 729,079</u>

Non-Appropriated Funds of Higher Education – Fund Balance
(Amounts in Thousands)



The Non-Appropriated Funds of Higher Education – Operations table includes the FY04 funds, summarized and compared to FY03. Financial statements for each of the individual funds are included in the statistical section of this report. The graph Non-Appropriated Funds of Higher Education – Fund Balance shows the combined fund balance for the past five years. The combined balance represents \$464 million for the University of Massachusetts, \$154 million for the State College system and \$111 million for the Community Colleges. These balances are designated for specific purposes, such as restrictions on endowments or other specialized purposes specified by the funding contributions.

Conclusion

The Commonwealth has many accomplishments in FY04 of which it can be proud.

The Office of the Comptroller continued its effort to build a more collaborative working relationship among members of this office and Chief Fiscal Officers (CFO) of the Commonwealth in a program we call "PARTNERS in Financial Management." The third CFO conference brought together CFOs from across the Commonwealth for two days of meetings. PARTNERS stands for people, accountability, responsibility, trust, negotiation, efficiency, risk assessment and mitigation, and solutions. We have enhanced the mantra that all systems, big and small, depend on people who are integral to those systems. This recognizes that fiscal officers of the Commonwealth are being given increased authority and at the same time being held accountable for their actions, ensuring a balance of efficiency and integrity of the financial operations of the Commonwealth. We must maintain this standard to maintain the public trust. We strike this balance between efficiency and integrity of operations through constant risk assessment and effective risk mitigation. Finally, we strive to find solutions to many of the Commonwealth's problems in conjunction with the rest of the CFOs, so that full input is heard.

The Commonwealth has eliminated a number of funds and adopted a more straightforward definition of fiscal balance which includes all of the budgeted funds except for the Inland Fish and Game Fund. The definition of fiscal balance that had previously only included the fund balance within three of the budgeted funds has been expanded to include all budgeted funds for FY05. In addition the number of budgeted funds has been reduced from 54 to 9.

The Commonwealth is in the midst of the most significant financial system upgrade in almost two decades. The Office of the Comptroller and the Information Technology Division have partnered with American Management Systems of Fairfax Virginia, and upgraded the Commonwealth financial management system to a web based architecture. The new system was placed into production opening FY05. This project will focus on changing business practices in order to minimize customization to this product.

This strategy will insure the Commonwealth can upgrade to current releases in the future at a reasonable cost. The goal is to keep current with technology in the future and at the same time control the total cost of system ownership. Benefits will accrue directly to the users of the financial system. In addition, this updated technology will allow for the future integration of Commonwealth internet-based applications into "back office" financial systems.

In this environment, the challenge of maintaining effective controls is greater than ever. We continue to ask each department, at its highest levels, to assess its risks and target controls to manage those risks efficiently and effectively. Toward this end, the Office of the Comptroller, in conjunction with the Office of the State Auditor, has continued a multi-pronged effort to improve controls throughout the Commonwealth.

I again would like to express my thanks to the many dedicated employees within the Office of the State Comptroller. We have had another successful year within the office. Our office has undertaken many tasks this year. We are embarking on the redesign of the state accounting system, MMARS. This will be a significant effort but will provide enduring benefits to the Commonwealth. I am proud to have all the employees of the Comptroller's Office on my team to help tackle these and other difficult issues of the future.

Respectfully submitted,

Martin J. Benison
Comptroller of the Commonwealth